CHASE

International Finance

Vol. XVI, No. 11
May 25, 1981

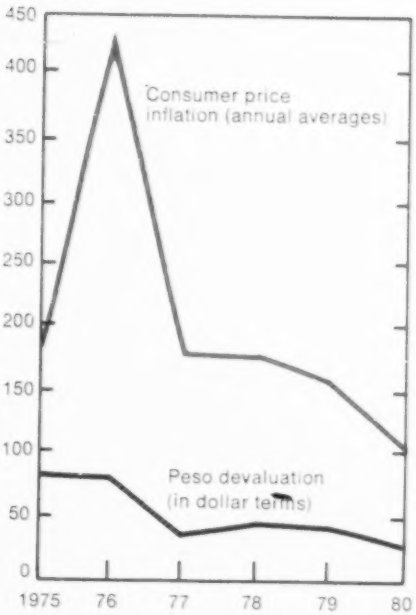
Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

New Exchange Rate Policy for Argentina

Last month's 22.7% devaluation of the Argentine peso in U.S. dollar terms signals a major change in Argentina's exchange-rate policy. The previous policy resulted in a significant appreciation of the peso in terms of its real purchasing power. Although average consumer prices in 1980 were up 100% from 1979, the average peso devaluation in U.S. dollar terms last year was only 28%.

The previous policy resulted in a significant overvaluation of the peso and was used by Argentina's monetary authorities as a means of promoting imports and lowering inflation expectations. It succeeded remarkably well. Imports rose 56% last year, and the annual rate of consumer price inflation dropped to 88% in December 1980 from 140% in December 1979. But the cost of the overvalued peso was considerable. Argentine exporting and import-competing firms suffered financial losses and bankruptcies, and some domestic banks went down with them. Exports increased only 2% last year, the trade balance shifted from surplus to deficit, and reserves fell by $2.7 billion. Interest rates surged from fears of a large devaluation, and overall real GDP grew by only 1.1%.

Argentine inflation and peso devaluation



The Argentine government's new policy is to maintain the real purchasing power of the peso—by adjusting its exchange value in accordance with the differential between domestic and international price rises. The government has left hazy its devaluation targets, indicating that the peso exchange rate will conform with measures to limit the fiscal deficit and the domestic money supply—two major influences on the inflation rate. A leading priority is limiting the central government fiscal deficit, which reached 4.2% of GDP in the first quarter of 1981. To assist the companies hurt by the old exchange-rate policy, the central bank is providing special discount lines through commercial banks. And to limit any resulting money supply increase, the central bank is engaging in open market operations and raising bank reserve requirements.

The shift to a more balanced currency policy promises an improved trade account for Argentina in 1981, in addition to agricultural and industrial gains. International reserves have already begun rising, and the pace of economic growth is expected to increase. Although a competitive exchange rate is not the only element needed to improve Argentina's economic performance, it is most likely to prove to be a critical one.

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New French government policy of reflation will likely entail faster money growth.

The Mitterrand victory will have little impact on the course of the French economy in the short run. A sustained economic recovery is not likely before the latter part of 1981, when the new government moves to reflate the economy. Reflation will be led by consumer spending and will show up in a widened budget deficit. This could lead to an enlarged trade gap and, possibly, higher inflation, depending upon the new administration's monetary stance. Financing the budget deficit will entail either a sharp rise in interest rates, faster money growth, or an increase in borrowing overseas. The new government is unlikely to favor the first of these options and Mitterrand himself opposes the last. But the remaining option of more rapid money growth is inconsistent with Mitterrand's commitment to fixed exchange rates. Thus, an early devaluation of the franc, perhaps in July or August, is highly probable. This could involve a downward adjustment of some 5% in franc intervention limits vis-à-vis the German mark, perhaps as part of a general realignment of EMS parities. In the interim, speculative pressures on the franc will likely be countered with continued high interest rates. Over the long run, continued high inflation will keep the franc under pressure and bring into question its role in the EMS. In the event, moves to tighten capital controls would be possible, an outcome whose anticipation has already produced a widening Euro-domestic interest-rate gap.

Sharply higher Swiss inflation assures continued high interest rates.

Swiss inflation accelerated sharply in the first part of 1981. During the first four months of the year, consumer prices advanced at an annual rate of over 10%. Short-term factors that have boosted prices include a rapid jump in food prices and the weakness of the Swiss franc (particularly in terms of the dollar), which has led to a sharp climb in energy costs. But the more fundamental cause of the resurgence in inflationary pressure is the fast monetary growth that occurred at the end of 1978. On the foreign exchange front, the margin by which Swiss inflation exceeds inflation in Germany is now its widest in six years. This has weakened the franc in recent weeks in terms of the German mark, particularly when the dollar has been firm against both currencies. Incipient franc weakness relative to the mark has been reflected in a narrowing of the Swiss-German interest diffrential. Swiss inflation is set to climb further in the short term, with higher mortgage rates in the pipline. The Swiss central bank is thus expected to retain its restrictive monetary stance, so that interest rates should at least remain at their current high levels.

Turkey's large current-account gap will necessitate financial assistance.

The Turkish current-account deficit is provisionally estimated to have widened to $3.1 billion last year from $1.7 billion in 1979, despite a 26% rise in export earnings. The bulk of the deterioration is attributable to a doubling of the oil import bill to $3.6 billion. For 1981, the Turkish authorities project a current-account deficit of $3.5 billion, with imports expected to climb to $9 billion and exports forecast to reach $3.8 billion. Recent pledges by 17 member-countries of the Organization for Economic Cooperation and Development of $950 million in loans and direct grants will help in financing the projected 1981 current-account gap. But substantial amounts of additional aid and capital inflows will still be needed if Turkey is to finance its current-account shortfall and amortize some $700 million in external debt.

Easing in Brazil's April inflation rate raises hopes of sustained moderation.

Brazil's basic inflation rate—computed from consumer, wholesale, and construction price indexes—fell sharply in April, hinting at the possibility of a sustained decline in the triple-digit rate of price increase. The 5.5% price rise in April compares with a 7.5% average monthly rate for the first three months of 1981 and with a 7% average monthly rate for the last quarter of 1980. The slower pace of inflation suggests that the impact of the government's price decontrol measures for many consumer goods has been absorbed. Also, the government's restrictive fiscal and monetary policies may have begun to bite. Still, despite the dip, the 12-month annualized change in the inflation rate was 120.6% in April, a reminder that Brazil has far to go in its battle on inflation.

A flurry of industrial projects brightens New Zealand growth outlook.

Real GDP growth in New Zealand in fiscal 1980-81 (ended March) is estimated at just 1%. The growth obtained was mainly the result of increased net real exports as real domestic demand actually declined. The outlook for the current and next fiscal years is, however, more promising. Indeed, it is reasonable to expect that the period of stop-go growth around a trend of no increase in real per capita income has ended. This optimism is based on stepped up investment spending on a series of major projects: the Marsden Point oil refinery expansion, aluminum smelter developments, the Taranaki petrochemical projects, and, possibly, the methanol, Mobil methanol-to-gasoline, and Glenbrook steel projects. Still, real economic growth over the next several years is expected to remain moderate, in the 2%-3% range. At the same time, the balance of trade and current account are likely to deteriorate because of the large import requirements associated with these projects and the rise in interest payments incidental to the incursion of new debt. But once the projects become operational later in the decade, New Zealand's external accounts should improve as the output of these various projects is exported or used to reduce imports.

Balance-of-payments improvement for Thailand hinges on higher agricultural productivity.

Stable oil prices have provided some relief to Thailand's hard-pressed balance of payments but it has been largely offset both by higher-than-expected interest rates on debt service and by the sluggishness of exports. In addition, some capital outflow is reported, with domestic investors lured by high rates and relative political stability abroad. Nonetheless, in line with the U.S. dollar, the Thai currency (the baht) has appreciated against the major European currencies—to a level unwarranted by underlying fundamentals. To aid nascent manufacturing firms regain some export competitiveness, the government allowed the baht to depreciate by 1.08% against the dollar in mid-May. Most observers maintain that Thailand's agricultural-commodity-based export sector benefits only marginally from currency depreciation, while a weaker exchange rate adds significantly to inflationary pressures. For this reason, a balance-of-payments turnaround ultimately depends on productivity advances in agriculture. But this will not occur until the government is able to implement long-overdue reforms in pricing policy and in the distribution system.

Nigerian current account to shift into deficit in 1981.

The glut in world oil markets this year has already caused a 10% cutback in Nigerian oil output. This, coupled with weakening oil prices, points to a dramatic near-term deterioration in Nigeria's external accounts. With 1981 export receipts —94% derived from oil sales—forecast at or below last year and imports at least one-third higher, the trade surplus is expected to shrink to about $1.1 billion this year from $8.1 billion in 1980. This will cause the current account to shift to a deficit of $4.4 billion from a $3-billion surplus in 1980. Half of this shortfall is expected to be covered by capital inflows, with the remainder financed by reserve drawdown. In the event, international reserves at yearend would still stand at $8 billion, a comfortable four months' import cover.

Prospects poor for recovery of cocoa prices.

World cocoa prices have declined steadily from their record levels in 1977. Current prices are running $0.78 per pound, compared with an average spot price of $2.03 per pound in 1977. World output for the October 1980-September 1981 season is expected to top the record 1979-80 level of some 1.6 million metric tons, and for the fourth consecutive year, world cocoa stocks will be built up. Stocks as of the start of the 1981-82 season are projected at approximately 700,000 tons—the highest level since 1965-66. Consumption has continued weak because of the growing use of substitutes and extenders and the economic slowdown in the major consuming nations. Meanwhile, the future of a new price-stabilizing International Cocoa Agreement is in doubt as the Ivory Coast and the United States, the world's largest producing and consuming countries, have refused to join. Cocoa prices are thus likely to remain near their present levels—or head even lower—constrained by the steady inventory accumulation of the last few years.

Consumer Bearishness Constraining Recovery

The surprisingly large revision in first-quarter GNP growth is prompting many economists to take a second look at their forecasts. The U.S. Department of Commerce announced last week that real growth in the first three months of the year occurred at an annual rate of 8.4% instead of the 6.5% rate reported earlier, indicating an economy substantially more buoyant than had been previously thought.

These new numbers, juxtaposed with other signs of strength in the economy, raise doubts that the second- and third-quarter growth setback projected in earlier forecasts will come to pass. Exports, which have been a consistent source of strength over an otherwise sluggish period, are expected to hold their own even though the economies of most of the United States' European trading partners appear likely to remain in the doldrums. Furthermore, there are indications that the U.S. economy is beginning to adjust to the higher levels of interest rates that have had such a crippling effect on certain sectors. Business investment—which is usually quite sensitive to interest rates—is now at a relatively healthy level and seems likely to stay that way. And while the housing sector still has some distance to go in its recovery, construction activity has picked up from year-ago levels, despite higher mortgage rates.

But for those economists still somewhat hesitant to abandon past predictions, there is also ample evidence that the spring and summer months could show little if any growth. The consumer sector, which accounts for two-thirds of GNP, remains listless. Retail sales of nondurable goods around Easter were reasonably brisk, but beyond that, financially strapped consumers have been pulling back on spending. Adjustment for inflation reveals that personal consumption expenditures have not increased since January. Mortgage delinquencies reportedly are up, and personal saving, despite a modest improvement to 3% of disposable income last month, is still quite low by historical standards. Personal income rose only 0.6% in April—the smallest percentage increase since last spring. And the weak housing market has put a considerable damper on homeowners' ability to cash in on capital gains as a source of additional funds. Consumers have been somewhat reluctant to turn to credit buying as well, as net extensions of consumer credit have continued to decline relative to income.

Without help from the dominant consumer sector, the economy could experience relative weakness, at least until fall when the expected implemention of a tax cut bolsters spending. Thus, the current weakness is likely to represent only a pause in the general cyclical recovery and expansion that has been taking place since the middle of last year.

Money Surprises and Interest Rates

Many observers have been puzzled by the heightened volatility of interest rates—often in unexpected directions—in response to announcements of money growth data. Take for example, the financial markets' reaction to M1-B growth for the week ending May 6. The markets had been anticipating an unusually large increase in the money stock (M1-B) for that week, based to a large extent on the tendency of M1-B to jump sharply in statement weeks ending on the sixth of each month. This tendency is attributed in part to the early disbursement of social security payments when the normal disbursement day falls on a Sunday. It is widely believed that the Federal Reserve's seasonal adjustment procedure does not adequately compensate for this "sixth day" effect.

When the Federal Reserve announced on May 15 that the increase in M1-B for the week ending May 6 was a sizable $3.1 billion, market interest rates *declined* sharply. This behavior may at first glance appear paradoxical. It contrasts with the abrupt *rise* in market interest rates following the announced $4.2-billion increase for the week ending April 22. And both the May 6 and April 22 increases in M1-B were obviously substantial—in the past 1½ years, on only eight occasions were the weekly increases larger.

To a great degree, the resolution to this apparent paradox lies not in the size of the *actual* increase in M1-B, but in the rise relative to the market's *expectation* of what the increase was going to be, which produces "announcement effects" in financial markets each Friday afternoon. Thus, it is chiefly when financial markets are surprised by the weekly behavior of the money supply that pronounced changes of interest rates occur. In fact, interest rates respond in a fairly consistent manner to the *unexpected* changes in the money supply, or to "monetary surprises". Evidence suggests that a smaller-than-expected increase in the money supply generally causes interest rates to fall, while a larger-than-expected climb causes them to rise.

When surprised by the behavior of the monetary aggregates, financial market participants reevaluate not only prior expectations of Federal Reserve policy, but expectations of the strength in money demand. For example, a large unanticipated increase in the money supply may lead to an upward revision in the markets' anticipation of total spending, and thus reflect unanticipated strength in money demand.

The increased emphasis of the Federal Reserve on controlling money growth has, of course, increased market attentiveness to money-stock changes. Thus, despite the imprecision of the weekly numbers, short-run money "surprises" are likely to continue, producing interest rate volatility on Friday afternoons for the foreseeable future.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALANCE OF PAYMENTS					MONEY AND BANKING							COUNTRIES
											12-month changes					exchange rate in U.S. dollars		
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	central bank rate	May 20, 1981	current monetary conditions	
Austria	Industrial production stagnating as unemployment begins to rise; no output growth expected this year.	Oct.	+ 3%	76.3	+ 3.6%	Mar.	4,459	+ 18%	2.3	0	German recession dimming export prospects.	Feb.	+ 7%	Feb.	+ 13%	6.75%	.0625	Credit moderately tight.	Austria
Belgium	Industrial production was up in February, but leading indicators continue to show weakening.	Feb.	— 13%	118.9	+ 1.5%	Mar.	6,064	+ 48%	1.1	0	European recession and overvalued franc hurting exports.	Apr.	+ 7%	Dec.	+ 2%	14.00%	.0269	Interest rates ease as pressure on franc moderates.	Belgium
Britain	First signs of end to recession just beginning to appear.	Mar.	— 9%	515.3	— 1.4%	Mar.	20,885	+ 5%	2.3	614	Current account continues to post massive surplus.	Mar.	+ 13%	Feb.	+ 10%	12.00%	2.0910	Prospects for further interest-rate reductions dimming.	Britain
Denmark	Economy remains in deep recession.	Jan.	— 3%	67.1	— 1.0%	Mar.	3,051	+ 66%	2.0	0	Trade deficit continues unremittingly large.	Feb.	+ 11%	Nov.	+ 7%	11.00%	.1418	EMS membership forces high rates in line with Germany.	Denmark
Finland	Economy continues to grow, but inflationary pressures mount.	Jan.	0	51.0	+ 6.0%	Mar.	1,779	+ 6%	1.4	82	Trade balance remains in healthy surplus.	Mar.	+ 13%	Nov.	+ 5%	9.25%	.2315	Monetary policy remains restrictive.	Finland
France	New administration plans to reflate economy.	Mar.	— 8%	651.1	+ 1.8%	Mar.	30,107	+ 43%	2.7	0	Consumer boom may widen trade gap in late 1981.	Mar.	+ 13%	Nov.	+ 10%	9.50%	.1811	Interest rates high to protect franc.	France
Germany	Industrial production drops in March after rises in January and February; domestic orders weak.	Mar.	— 5%	827.7	+ 1.8%	Mar.	50,071	+ 8%	3.4	0	Sharp rise in foreign orders points to narrowing of current-account gap.	Apr.	+ 6%	Feb.	+ 4%	7.50%	.4369	Fall in rates unlikely until U.S. rates decline.	Germany
Greece	Reflationary investment budget in place in advance of November elections.	Sept.	+ 1%	41.0	+ 0.6%	Feb.	1,009	+ 12%	1.2	85	Oil bill officially expected to rise to $3.6 billion in 1981.	Feb.	+ 26%	Nov.	+ 19%	20.50%	.0180	Credit eases somewhat.	Greece
Ireland	Industrial production continues depressed, but there are signs of small upturn.	Nov.	— 6%	17.6	+ 1.9%	Mar.	2,518	+ 24%	2.8	0	Exports reasonably strong, but heavy imports will yield large payments gap.	Nov.	+ 18%	Feb.	+ 18%	12.75%	1.6050	Budget gap, unease about possible elections keep rates high.	Ireland
Italy	Sharp rise in industrial production in February unlikely to be sustained.	Mar.	— 4%	392.8	+ 4.0%	Mar.	17,973	— 6%	2.2	0	Lira devalued 6% vs. DM to prevent further drop in competitiveness.	Apr.	+ 20%	Nov.	+ 11%	19.00%	.0008757	Pressure on lira eases after devaluation.	Italy
Netherlands	Government introduces further spending cuts despite weakening economy.	Mar.	— 7%	160.8	+ 1.2%	Mar.	10,965	+ 29%	1.8	0	Exports hurt by European recession, but higher gas prices limit payments gap.	Apr.	+ 6%	Jan.	+ 7%	9.00%	.3930	Interest rates ease; guilder remains strong in EMS.	Netherlands
Norway	Despite buoyant oil sector, real GDP growth in 1981 unlikely to reach 1%.	Feb.	— 4%	56.7	+ 3.5%	Mar.	5,255	+ 18%	3.8	0	Payments balance remains strong, but exports threatened by high prices.	Mar.	+ 14%	Jan.	+ 12%	9.00%	.1777	Inflation building, forcing continued tight money policy.	Norway
Portugal	World recession likely to hamper strong economic growth.	June	+ 7%	24.1	+ 3.9%	Feb.	552	— 20%	0.8	106	Widening of current-account deficit to $1.6 billion forecast for 1981.	Jan.	+ 16%	Nov.	+ 24%	18.00%	.0164	Monetary growth still rapid.	Portugal
Spain	Likelihood of poor agricultural crop clouds domestic economic outlook further.	n. a.	—	208.5	+ 0.5%	Jan.	11,566	— 14%	4.0	237	Prospects for 1981 poor, but weaker peseta enhances competitiveness.	Jan.	+ 14%	Dec.	+ 14%	8.00%	.0110	M3 growth eased to 15.6% in February.	Spain
Sweden	Real GDP growth remains sluggish.	Jan.	— 3%	124.3	+ 2.3%	Mar.	4,138	+ 23%	1.6	0	Current-account gap expected to remain in kr. 12-billion range.	Feb.	+ 13%	n. a.	—	12.00%	.2057	No change in central bank's tight monetary stance.	Sweden
Switzerland	Economic downturn likely after midyear.	Dec.	+ 1%	99.8	+ 2.4%	Mar.	12,884	— 4%	4.6	0	Trade deficit of $1 billion posted in first quarter.	Apr.	+ 6%	Jan.	— 3%	5.00%	.4920	Monetary policy remains tight.	Switzerland
Canada	Gains in paper, metal, and electrical-product output give strong boost to manufacturing output rate.	Feb.	+ 1%	246.5	+ 0.1%	Mar.	2,816	+ 4%	0.5	0	Reserves decline as $300-million IMF standby credit is repaid.	Apr.	+ 13%	Feb.	+ 6%	18.71%	.8327	Money supply targets lowered to 4%-8%.	Canada
United States	Economy in 1981: fast start, slower now, pick-up by late summer.	Apr.	+ 3%	2,627.0	— 0.1%	Mar.	19,256	+ 87%	0.9	0	Current account for 1981 likely to be in rough balance.	Mar.	+ 11%	Apr.	+ 2%	14.00%	—	Strong short-term credit demands sustain high rates.	United States

World Interest Rates

market rates of May 20, 1981; bond yields as of May 15, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	18.98	12.00	14.00	9.50	7.50	19.00 penalty rate 22.00	9.00	5.00	6.25
Day-to-Day Money	20.00 May 21	19.50	11.00	12.10	17.50	11.80	19.75	10.25	0.50	7.4375
Treasury Bills 91-day, Middle Rates	16.61	18.80	11.375	17.00	n. a.	n. a	18.40 99-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	17.95 finance paper	19.10 finance paper 15% tax w/h	10.91	13.90 Certified	17.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	17.75	19.10 15% tax w/h	11.5625	13.90 Certified	not traded	9.90	21.10	no market	n. a.	no market
Government Bonds Long-term, new and old issues, average yield	13.56	15.60	14.03	10.21 20% tax w/h	15.94	10.41	18.64	11.94	5.85	8.34
Industrial Bonds prime, long-term, new and old issues, average yield	14.60 Aa Industrials	16.25	14.93	15.11	17.13	10.91	19.41	12.91	6.23	7.10
Bank Short-Term Rate to Best Borrowers (prime rate)	20.00	19.50	13.00	18.75	14.35	14.25	22.50 ½ quar ly fee on outstdng	13.00	8.00	6.75
Bank Time Deposits 3-month	17.50 Cert. of Dep	18.75	12.1875	16.75	17.375	13.20	10.75	11.75 large deposits	9.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	18.375	no market	12.3125	no market	19.75	12.875	no market	11.75	9.6875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8327	2.0910	.0269	.1811	.4369	.000876	.3925	.4900	.00454
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.375 *P*	6.50 *P*	8.50 *P*	2.25 *D*	5.50 *P*	2.75 *D*	6.25 *P*	8.75 *P*	11.00 *P*

Eurodollar Deposits
(London, interbank, bid)
May 21

7-day	19.0625
1-month	20.4375
3-month	19.25
6-month	18.3125

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.11
U.S.-Canada Treasury Bills	−1.48
U.S.-Canada Finance Co. Paper	−1.312
Eurodollars-U.K. Local Auth. Deposits	− .25

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.75*
Over 7 yrs.	15.25*
DM Bonds	
7 yrs. and under	11.375*
Over 7 yrs.	10.125*

Gold Price
London afternoon fixing
479.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Bond yields as of May 13, 1981.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	10.6 (Mar.)	12.6 (Apr.)	12.6 (Mar.)	12.5 (Mar.)	5.5 (Apr.)	19.9 (Apr.)	5.6 (Apr.)	6.2 (Mar.)
Industrial production*	3.0 (Apr.)	0.5 (Feb.)	9.2 (Mar.)	8.0 (Mar.)	5.3 (Mar.)	4.1 (Mar.)	1.0 (Dec.)	1.7 (Mar.)
Trade balance† *(billions of local currency units)*	$0.45 (Mar.)	C$0.51 (Mar.)	£0.31 (Feb.)	FF1.93 (Apr.)	DM0.14 (Mar.)	Lit.1,530 (Feb.)	SF0.71 (Apr.)	¥323 (Apr.)
Money supply (M1)*	1.6 (Apr.)	6.4 (Feb.)	10.0 (Feb.)	10.0 (Nov.)	4.3 (Feb.)	11.5 (Nov.)	3.0 (Jan.)	2.4 (Jan.)
Velocity of money (M1)*	4.6 (Dec.)	0.14 (Dec.)	11.4 (Sept.)	n. a.	0.6 (Dec.)	6.6 (Sept.)	n. a.	12.6 (Sept.)
Reserves minus gold *($ million, change from previous month)*	730 (Mar.)	372 (Mar.)	138 (Mar.)	472 (Mar.)	3,244 (Mar.)	2,652 (Mar.)	1,156 (Mar.)	333 (Mar.)

* Percent change from 12 months earlier.
† Figures are only for the month indicated.

Philippine Economic Weakness Continues

The pace of real economic growth in the Philippines fell short of official targets last year, dropping to 4.7% from 5.8% in 1979. The combination of sharply higher oil import prices and depressed world prices for key commodity exports played havoc with the Philippines' balance of payments and increased external indebtedness dramatically. A double-digit inflation rate compounded the economic difficulties, which together forced the pursuit of moderately restrictive monetary and fiscal policy.

The outlook for 1981 is not much more promising. The domestic economy is expected to continue in low gear, with real GNP projected to rise only marginally. Still, the balance-of-payments deficit is expected to widen and spur a further increase in external debt. Financial assistance from the International Monetary Fund and the World Bank, however, will preclude any deficit-financing problems.

A close-up view of the economy in 1980

The weakness that characterized the Philippine economy last year was the result of three basic influences: sharply higher oil prices, which boosted the 1980 oil import bill to $2.2 billion from $1.4 billion in 1979, despite a small drop in import volume; disastrously low export prices for copra and coconut oil, which cut into cash incomes throughout the Philippines; and the restrictiveness of domestic monetary and fiscal policy, which was aimed at reducing inflation and the external-payments deficit and which was also in compliance with the terms of a two-year standby agreement with the IMF.

The 4.7% growth in 1980 was led by an expansion of mining production, which posted 9.2% growth last year—stimulated by high prices for gold and copper and fast growth of the utilities. An advance of 6.8% in farming, fishing, and forestry also helped. But the pace of manufacturing growth declined slightly, owing to weakness in the consumer-oriented industries. And the performance of the construction and transportation sectors was also down.

Despite the domestic sluggishness, consumer prices rose at a 17.8% year-over-year rate in 1980, after an 18.8% rate of price rise in 1979. A contributing influence was the government's policy of passing higher crude import prices through to consumers.

The restrictive monetary policy last year held the rate of money supply (M2) growth to just under 18%. With an inflation rate of roughly the same magnitude, liquidity was squeezed, and a fairly large number of firms fell into financial difficulty. This triggered credit assistance to firms and was in turn followed by the Philippine central bank's approval of new interest-rate regulations. Effective July 1, 1981, ceilings will be lifted from time deposits and from debt with terms of more than two years. Debt of less than two years' maturity will continue subject to ceilings, but even these appear provisional. These measures reveal a desire to maintain relatively high interest rates to minimize speculation and bolster savings in the face of high inflation, and to encourage longer-term lending by the commercial banks. They complement the terms of the 1980-81 IMF standby agreement, which calls for ceilings on domestic credit growth and on other financial variables, as well as ceilings on external loan commitments. And they have been accompanied by other financial-sector reforms aimed at increasing financial institutions' flexibility and efficiency.

The Philippine external accounts suffered badly last year. The trade deficit widened to $2.1 billion from $1.5 billion in 1979, and with a deterioration in net services earnings—owing largely to higher interest payments on external debt—the current-account gap expanded to $2.4 billion from $1.6 billion a year earlier. The major cause of the worsening was the higher cost of 74 million barrels of imported oil. Indeed, the $2.2-billion 1980 oil import bill could have been far higher were it not for the 1.6% drop in import volume. On the plus side, strong sugar export earnings compensated for depressed coconut oil receipts, and manufactured exports—which now account for almost one-third of total exports—increased by 34%.

ECONOMIC INDICATORS

	1977	1978	1979	1980 est.
Real GNP Growth, %	5.7	6.3	5.8	4.7
Consumer Price Rise, %	7.9	7.6	18.8	17.8
Current-Account Balance (million dollars)	827	1,274	1,561	−2,400
External Debt, Long-Term (million dollars)	5,554	6,838	9,778	12,270

The expanded current-account gap resulted in a net addition to external debt last year of $2.5 billion, and the Philippine debt-service ratio reached 18.7%. The 1980-81 IMF standby eased the deficit funding by providing $338 million, over and above $1.2 billion in other medium- and long-term loans. In addition, the World Bank extended a $200-million program loan.

The current outlook

The domestic economy is not expected to experience any significant rebound this year. Commodity prices remain weak, government policy continues restrictive, and high oil prices are still taking their toll. Overall,

Philippine Economic Weakness Continues *(continued from page 7)*

inflation-adjusted economic growth of about 5.8% is officially forecast. Externally, the current-account deficit for 1981 is expected to expand slightly—perhaps to about $2.7 billion. Again, the cost of imported oil will continue to be the chief contributor to the sustained external-account deterioration. The 1981 oil bill is forecast at $2.7 billion.

Prospects for domestic oil output offer little relief. Domestic oil production has dwindled to a mere 4,000 barrels per day, and although two new oil fields are scheduled to come on stream later this year, their combined output is projected at only 60,000 barrels per day. All told, the Philippines' domestic oil reserves are not ever likely to be able to satisfy more than 15%-20% of domestic oil needs. The government's publicized energy program, however, does hold some promise of reducing the role of imported oil in total domestic energy consumption to 50% from 90%. The program is aimed at maximizing the utilization of domestic energy sources of coal, hydroelectric, and geothermal power.

Funding of the 1981 external deficit will once again be aided by the IMF and the World Bank. The IMF standby will provide $195 million and a second World Bank program loan of $200 million is expected. Furthermore, the IMF's ceiling on 1-12-year borrowings has been raised to $2.05 billion, including $350 million in added financing for a nuclear power plant. The Philippines' total debt-service ratio in 1981 is not expected to rise from its 1980 level. Indeed, despite its rapidly rising debt-servicing costs, the Philippines' debt-service ratio is expected to remain moderate through 1983. Still, the size and growth of external debt and its service render the Philippines vulnerable to the vicissitudes of its external terms of trade.

Fundamental weaknesses in the economy

While the pace of economic growth in the Philippines in the 1969-79 period averaged 6.1% per annum, well above the 1980 and current growth rate, even this performance was poorer than that of most other East Asian countries over the same 10-year period. Thailand's annual average real GDP growth rate between 1969 and 1979 was 7.7% and Indonesia's was 7.5%.

The reasons for the Philippines' history of relatively slow growth have much to do with the country's physical characteristics, rather than with faulty economic management. The Philippines is essentially a collection of some 7,000 islands, of which 880 are inhabited and largely mountainous. There is also no common language. Thus, transport and communications problems are enormous. In addition, the combination of an insufficient supply of arable land and a relatively large population, whose annual growth rate is now about 2.4%, has necessitated the import of growing quantities of food—despite significant progress in boosting agricultural output. Finally, the prices of the Philippines' exportable commodities are not only volatile in world markets, but they have suffered a long-term decline relative to imports. To be sure, the secular deterioration in terms of trade has accelerated since the oil price explosion of 1973, but it actually began well before then. The decline has reduced the real earning power of Philippine exports by more than 60% in the last 30 years.

Perhaps the Philippines' greatest assets, however, are its human resources. The country's motivated and capable work force is rich with managerial as well as ordinary labor talent and is far from fully employed. Thus, an important potential stimulus to further economic development is improved utilization of local manpower. The rapid growth in recent years of labor-intensive manufacturing for export points the way.

Political uncertainty clouds near-term outlook

In contrast to the relatively lackluster economic climate, the political situation has been turbulent. A chain of events was set in motion after President Ferdinand Marcos announced an end to martial law on January 17. The move was followed by a plebiscite to replace the parliamentary form of government with a strong presidential system—which won approval on April 7. The focus is now on June 16, when presidential elections are scheduled. President Marcos is projected to win reelection, which will continue his political leadership for another six years. Nonetheless, there is opposition to Marcos' rule, and several groups appear to be testing the limits of liberalization in the wake of the lifting of martial law. Labor, for one, is stirring, and several strikes have already been called. The Philippines' actual economic performance in 1981 is thus subject to the course of political, as well as economic events, whose outcome is still unknown. Yet the Philippines' sound economic management offers the hope of stable, if not rapid, economic growth in 1981 and beyond.

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